CMH Wealth Management, LLC

Issue 18

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Staying the Course

As we entered 2024, we anticipated economic normalization and a shift from monetary tightening to easing. We also emphasized the strong fundamentals of the "Magnificent Seven" (today's dominant seven stocks) and the long-term benefits of Artificial Intelligence (AI). The stock market, particularly the Magnificent Seven and companies associated with AI, had strong positive returns in 2024.

The S&P 500 was up 25% for calendar year 2024. While staying disciplined during market downturns is crucial, maintaining resolve during rising markets is equally important. Media often highlights new market highs as a potential warning, as though markets must return to some previous number. While markets do not move in straight lines, economic growth and improved corporate profits have led to new market highs in every decade.

At the start of each year, analysts predict equity index price targets and usually forecast modest single digit gains. History shows that substantial market movements are more common. Over the past century, annual stock market gains of 10% to 20% were more likely than 0% to 10%. Stocks gained 20% or more almost 40% of the time, according to Deutsche Bank data. Conversely, stocks had negative returns 26% of the time. Modest return years are less frequent, but often feel safer to predict.

Consecutive 20% annual gains are also rare, occurring only four times in the S&P 500's history. After significant gains in 1935 and 1936, the market plunged in 1937 due to Fed and fiscal policy changes. Things were better after the 20%-plus rallies of 1954 and 1955, with the S&P rising a modest 2.6% in 1956. The more recent trend of gains began in the mid-1990s, with stocks rising 20% or more from 1995 to 1999. Investors that sold out at the end of 1996, after two years of strong equity market returns (34% & 20%), may have missed out on a three year bull market (up 31%, 27%, & 20%) before the 2000-2001 correction arrived.

After two consecutive years of equity returns over 20%, could we be facing a momentum reversal or market cycle downturn? Deregulation, lower taxes, and AI productivity could continue to support stocks by boosting profit margins and earnings. However, potential impacts from tariffs, immigration policy, and prolonged above-trend inflation could offset these positive trends.

One fact remains: the stock market has risen substantially in recent years, driven more by momentum than broad profits. While markets can continue to move positively, we have entered the New Year with caution/vigilance.

Annual Returns Last 25 Years
US Stocks vs. US Bonds

Year Ending	S&P 500 Index	BB Agg Bond Index
2024	25.0%	1.3%
2023	26.3%	5.5%
2022	-18.1%	-13.0%
2021	28.7%	-1.5%
2020	18.4%	7.5%
2019	31.5%	8.7%
2018	-4.4%	0.0%
2017	21.8%	3.5%
2016	12.0%	2.6%
2015	1.4%	0.6%
2014	13.7%	6.0%
2013	32.4%	-2.0%
2012	16.0%	4.2%
2011	2.1%	7.8%
2010	15.1%	6.5%
2009	26.5%	5.9%
2008	-37.0%	5.2%
2007	5.5%	7.0%
2006	15.8%	4.3%
2005	4.9%	2.4%
2004	10.9%	4.3%
2003	28.7%	4.1%
2002	-22.1%	10.3%
2001	-11.9%	8.4%
2000	-9.1%	11.6%
Average Annualized	**7.7%**	**3.9%**

Table Source: Tamarac, S&P Dow Jones Indices, Bloomberg Barclays US Aggregate Bond Index

2025 Portfolio Positioning

Asset Allocation

We began 2024 with our smallest overweight to equities and the smallest underweight to bonds since 2018. We still favor equities over bonds, but the risk-reward ratio has significantly narrowed. High-quality bonds now offer yields comparable to those in the stock market. At year-end, the equity risk premium, defined as the forward earnings yield of the S&P 500 minus the U.S. 10-year yield to maturity, was 0.08%. When this equity risk premium is zero or negative, the stock market is essentially pricing itself like a risk-free asset. While higher-than-historical equity valuations remain a hurdle going forward, these indicators alone should not be used as a market timing mechanism.

Last year, we coined the phrase “Fixed Income – Bonds are Back!” This year, our view is “Bonds are Still Here and Even Stronger!”

Equities

Despite our enthusiasm for bonds, we still believe equities should remain healthy over the intermediate-term. The consumer has remained very strong over the past year, contributing 78% to overall growth, which is above the long-term trend of 70% for the U.S. consumer. While we expect less contribution from the consumer, and possibly the government, the economy is still expected to grow in the coming year.

The U.S. equity market is trading at a 12-month forward price to earnings ratio (valuation measure) well above its 20-year high. High valuations in some areas provide motivation for diversification. We anticipate a broadening stock market that should finally favor companies outside the mega-cap names. U.S. small- and mid-cap companies remain at large valuation discounts to large-cap companies and are also more domestically focused. This can insulate them from overseas risks.

From a pure valuation perspective, international stocks remain attractive. That is where the positive comments end. International stock markets offer less exposure to growth-sensitive sectors (technology) and come with varying degrees of political and economic risks. While some markets look attractive to us, such as India, a broad basket of international stocks remains out of favor in our current positioning. Over the last decade, the U.S. stock market has produced an average annual return of 13.1%, while international developed stocks have returned just 4.9% annually. Our strategic bias and overweight towards U.S. stocks has worked well and remains in place.

Fixed Income

Bonds are arguably more attractive now than in previous decades, especially when measured against other assets (stocks). The term “sound money” fits perfectly when considering the safe income you can earn above inflation by investing in high quality bonds.

We entered 2024 by stating that the Federal Reserve was too restrictive, with interest rates well above the expected long-term rate of inflation. The Federal Reserve ended up cutting its main interest rate by a full percentage point, ending the year at 4.25%. In more recent months, data has suggested inflation has stopped declining. The Fed has also expressed concern with continued rising debt levels due to aggressive fiscal policy. While we still consider the current interest rate level as restrictive, the Fed may become more cautious and slow the pace of future rate cuts.

We expect inflation to continue to stabilize in the coming years and do not expect new tariffs (if they occur) to have a long-term impact on price stability. Even if long-term rates are pressured by debt or deficit challenges, there is still more than enough income to offset any price declines. Bonds have a

2025 Portfolio Positioning (cont.)

high starting yield, which will provide a hedge against any upward pressure in interest rates. Considering the following scenarios, bonds remain a great investment:

- **Hard landing** (recession and/or deflation): yields decline, prices of current bonds go up
- **Soft landing** (moderate labor weakness, average growth without a recession, positive inflation): some rate cuts = prices are up and investors capture stable income
- **Acceleration** (measured inflation, higher growth is good for improving debt levels): yields are already high, so income outweighs any short-term price decline

The long-term case for bonds remains strong!

Here's a summary of our current portfolio positioning:

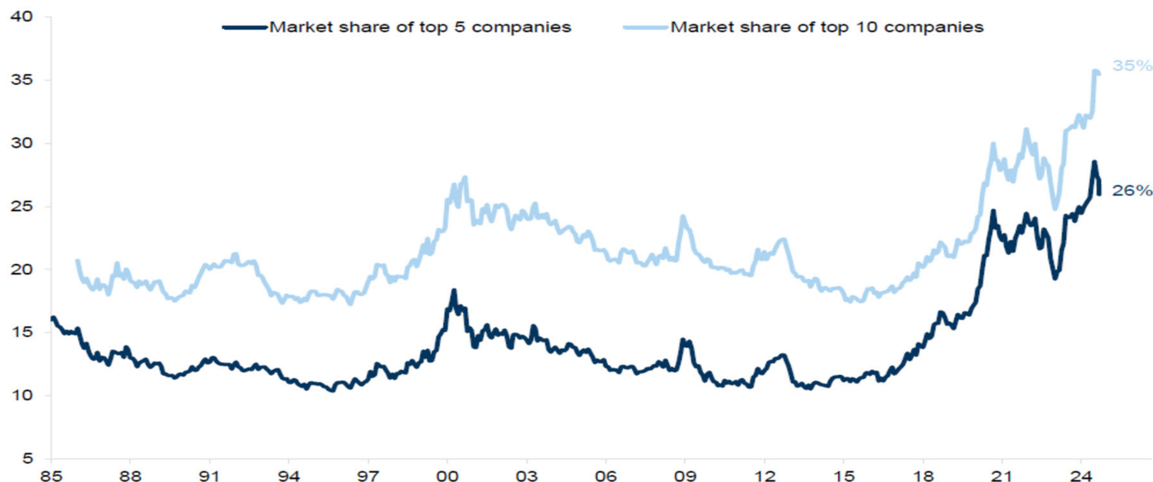
Asset Class	Summary of Current Tactical Views
Fixed Income	Marginally underweight relative to equities. Favoring a neutral view on interest rates with an overweight to high quality corporate bonds. Using treasuries for liquidity and tactical portfolio positioning.
Equity	Smallest overweight since 2018 relative to fixed income. Overweight high quality but diversified U.S. large cap equities.

Addressing Market Concentration

In equity markets, narratives and sentiment play a crucial role in attracting and directing capital. This flow of capital can potentially distract investors from other promising opportunities. Consequently, an equity index may become concentrated in specific sectors or companies. The chart below illustrates the increasing concentration of the stock market in recent years. The market capitalization of the 10 largest S&P 500 companies now constitutes 35% of the total index, marking the highest level of concentration since 1932.

Exhibit 1: The current scale of market dominance

Market value of the biggest companies of the S&P 500 as a percentage of the index market value:



Source: Datastream, Compustat, Goldman Sachs Global Investment Research

Addressing Market Concentration (cont.)

It is clear U.S. large-cap technology companies have been the most important driver of strong equity returns in the last two years. There are valid reasons:

- Earnings are significantly higher, and growing faster, than the rest of the U.S. and global stock markets;
- Artificial intelligence is transformational;
- Mega-cap fundaments are still solid (sales, cash flow, and earnings);
- Large-cap companies took advantage of low borrowing costs prior to 2022 to protect their balance sheets from rising interest rates;
- The U.S. is still the most attractive stock market in the world, with durable growth, stable and growing earnings, a trusted regulatory environment, and a strong culture of promoting innovation.

There are inherent risks associated with this technology-led concentration. As these stocks perform well, their market capitalization increases. This increases their weight and size in most equity indices. It is estimated that 50% to 60% of new inflows to the equity market go into passive investments. Irrespective of valuation, surging stocks are automatically being purchased in greater proportion.

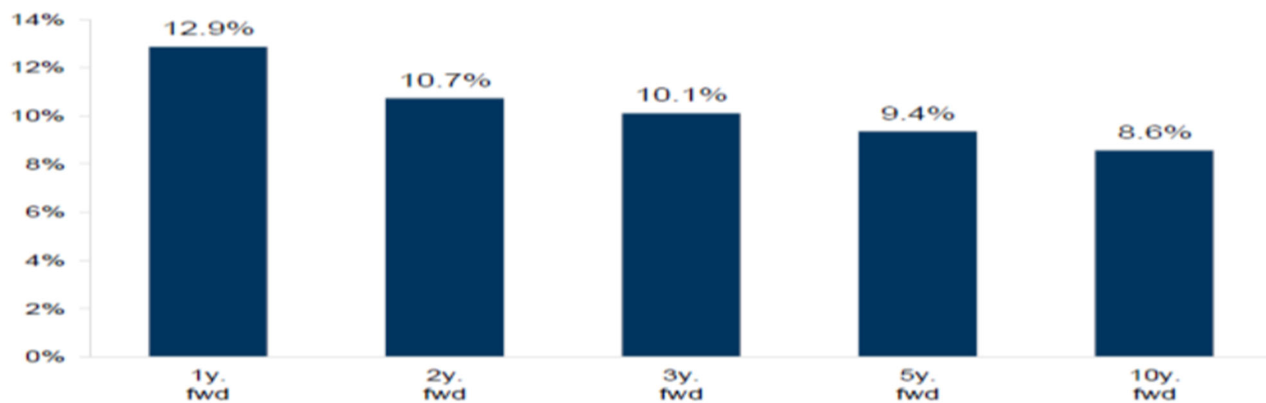
Another risk of concentration is the challenge of sustaining high levels of sales growth and profit margins over extended periods. Over the past 40 years, the proportion of companies able to grow sales at 20% over a decade has sharply declined, with only 3% of firms maintaining this growth rate for 10 years. Fewer than 1% of firms have maintained margins of over 50% for 10 consecutive years, indicating that profit growth is likely to moderate.

Other fast growing companies may emerge and outperform. Only five of today's top ten companies were in the top ten in 2015. Two were in the top ten in 2010, and only one company was also in the top ten in 2005. Investing is ever-changing and dynamic!

These companies did not even exist before the 1990’s: Amazon, Alphabet, Nvidia, Salesforce, Tesla, Meta, and Netflix.

Exhibit 2: Absolute returns remain good for dominant companies

Average forward realized absolute return (US Top 10 companies). Since 1980:



Source: Datastream, Goldman Sachs Global Investment Research

Addressing Market Concentration (cont.)

Historical trends indicate that the dominant companies of today may not be the dominant companies of the future. This does not imply that these companies are poor investments; rather, it suggests that today's dominant companies face headwinds in being the fastest-growing companies over the next decade.

Although they may not maintain their dominance in the future, there are still many positive aspects to appreciate about these companies. When comparing against the dominant companies of 2000, current companies boast:

- Significantly more profitability than in 2000. Net margins are 28% vs 16%;
- Stronger balance sheets than those in 2000. Cash as a percentage of market cap is now 4.2% vs 1.7%. Net debt to equity is -30% vs 4% (lower percentage means less debt);
- Reduced spending. In 2000, companies were spending more than 100% of operating cash flow on research and development. Today it is only 72% of operating cash flow. This compares to a 40-year median of 67%;
- Lower valuations than in 2000. The median price to earnings ratio is 24, compared to 52 in 2000. The enterprise value-to-sales is now 5, versus 8.2 in 2000. Higher numbers typically indicate more overvalued.

Today's dominant companies are fundamentally sound, and concerns about extreme overvaluation seem exaggerated. However, history shows that dominance does not last forever. This is due to competition, companies becoming too large to grow, the law of diminishing returns, and regulatory risks. Therefore, continued portfolio diversification is a strong discipline and should prove rewarding in the future.

Artificial Intelligence (AI)

A common theme among today's dominant companies is their exposure to Artificial Intelligence (AI). Some define AI as a machine's ability to perform cognitive functions typically associated with human thinking, processing, learning, and reasoning. We wanted to know what AI was thinking of itself. So, we asked AI "What are the potential uses of AI?" Here is what these artificial intelligence models shared with us, to name just a few:

Health:

- personalized medicine after reviewing individual's genetic history
- drug discovery through accelerating and analyzing vast amounts of clinical data
- medical diagnosis through analyzing X-rays & MRIs accurately & efficiently
- wellness monitoring through wearable devices
- processing massive datasets (physics, genomics, astronomy) and running simulations

Business & Finance:

- predictive analysis of business, sales, and market trends / forecasting
- manufacturing quality control, process improvement, and robotics automation
- risk assessment and creditworthiness analysis of potential borrowers for lenders
- analyzing data to detect fraudulent activity and suspicious patterns
- improvement of chatbots and online help functions as a customer support tool

Artificial Intelligence (AI) (cont.)

Personal Use:

- fitness, health, smart homes (heating, lighting, security), and voice assistants

Environment & Agriculture:

- wildlife conservation through tracking endangered species and combating poaching
- predicting climate changes and mitigating effects through pattern-seeking data analysis
- optimizing agriculture processes and minimizing use of pesticides and fertilizers
- precision farming through crop, soil, irrigation analysis and resource management

Transportation & Energy:

- route optimization, logistics planning, traffic management, and autonomous vehicles
- energy optimization analyzing weather patterns and power grid demands

Entertainment & Education:

- image, art, music, literature, gaming creation, and personalizing these results
- tutoring, automated grading, personalized learning, and customized teaching
- educational content creation and language learning tools

Security & Law Enforcement:

- analyzing potential physical and cybersecurity threats and risks
- aiding case analysis and legal documentation
- surveillance systems and emergency response management

"What risks face AI?" AI believes issues surround itself such as accountability, privacy, plagiarism, social manipulation, copyright law, concentration of power, ethics, misinformation, over-reliance, economic inequality, algorithmic manipulation, bias, autonomy, discrimination, erosion of human skills, security vulnerability to the large language model, etc. Like any new technology, job displacement becomes a concern.

These risks require thoughtful discussion to ensure the ethical and responsible development and deployment of AI technologies. AI should augment human decision-making rather than replace it entirely. Human oversight is a must.

Who did we actually ask? We asked Gemini (Google), Claude (Anthropic), Chat GPT (Open AI) and PerplexityPro (Perplexity). These are all apps/websites you can download and/or visit.

*The picture is the result of asking Microsoft CoPilot to create a visual representing AI.

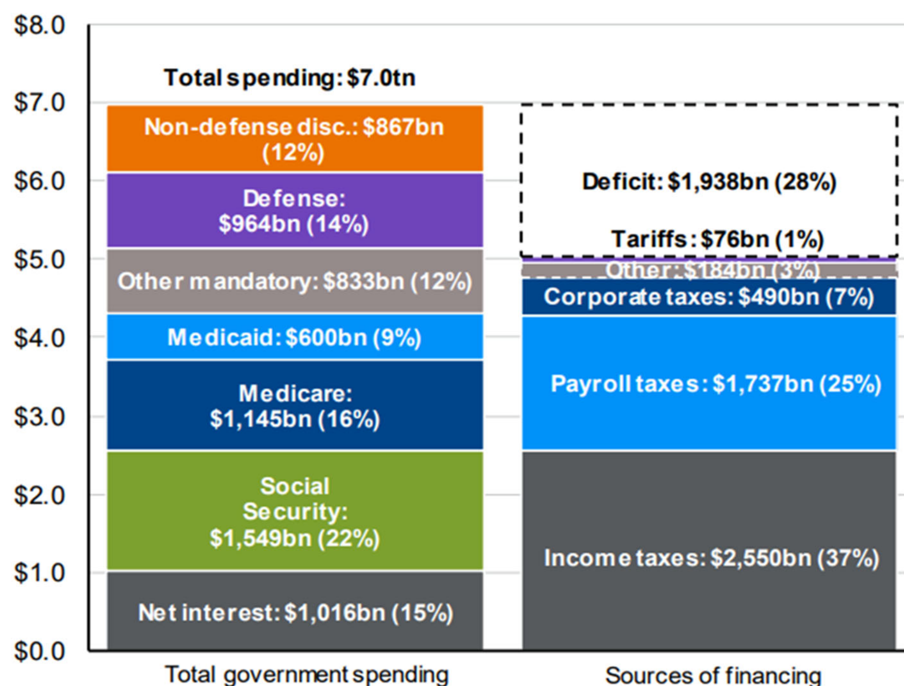
U.S. Debt Levels

The Congressional Budget Office (CBO) projects that the U.S. deficit will average 6.7% over the next 30 years. The deficit is a measure of the amount by which total spending outlays exceed revenues. In the fiscal year 2023-24, the deficit was 6.3%, even with a fully functioning economy. This elevated deficit level during peacetime has only been seen during the Great Financial Crisis (GFC) and Covid. It exceeds even those recession years before the GFC, suggesting our government is spending at a rate typically associated with a recession or war. By 2034, interest payments on outstanding debt are expected to be 4.1% of GDP, making up about one-sixth of federal spending.

You might be wondering how we got here. When discussing government debt levels, we need to address the concepts of "fiscal space" and "debt sustainability." Fiscal space is the margin available in the budget for spending, without harming financial conditions. The U.S. has been able to bail out crises like the GFC and Covid because of its strong economy, low taxes, stable currency, and other factors. In other words, it has enjoyed "fiscal space". Without government support, the economy may have struggled to quickly recover from these economic shocks. "Debt sustainability" refers to the ability to maintain a certain level of debt as a percentage of GDP. There's no exact point when debt becomes unsustainable (Japan debt-to-GDP ratio at 260% vs. U.S. at 121%), but if debt grows too much, investors might demand higher interest rates, increasing borrowing costs for the US. This scenario can lead to a debt spiral where increased borrowing is required to service the increased costs. This negative scenario compounds upon itself.

Forecasting debt and deficits is challenging because the CBO's projections assume constant spending and revenue. Changes in laws, specifically those affecting revenue and spending, can significantly alter these outcomes. The CBO's projections also do not account for major events like recessions, wars, pandemics, or supply shocks. The hurricanes in Florida and wildfires in California are examples of new, unplanned risks. We are likely to see sustained deficits and higher debt/GDP levels, but to what extent?

The 2025 federal budget is comprised of 74% mandatory spending, directed by existing laws. The majority of this mandatory spending category (entitlement programs) is not expected to experience spending cuts. While we do believe the government needs to reign in spending, the debt to GDP ratio can also be impacted on the growth side.



There is an argument to be made that the debt we are accruing will contribute positively to economic growth. As an example, several large chip companies (Micron, Qualcomm & GlobalFoundries, etc.) have announced investments of over $50 billion into onshoring chip foundries based on incentives from the government. Currently we rely on over 75% of global chip production coming from East Asia, with a majority of that coming from Taiwan.

Similarly, the government can incentivize spending on AI, with the potential for improved productivity for corporations. An increase in corporate profitability could increase overall growth, organically contributing positively to the debt to GDP ratio. Productive debt is good debt.

Optimism with Caution

We ended last year's newsletter with the idea of "Economic Normalization". The decade began with extraordinary government stimulus to address the COVID shock. We then quickly transitioned to a period of monetary tightening, reversing the liquidity and historically low interest rates. Over the last year, we have seen a bit of "normalization" as the Federal Reserve reduced short-term rates and has slowly reduced their balance sheet.

We are now straddling the line between Quantitative Easing ("QE", low rates and easy money) and Quantitative Tightening ("QT", higher rates and tightened money supply).

- The Fed is still "easing" (QE) with interest rate cuts, but the pace has slowed.
- At the same time, since 2022 the Fed has been "tightening" (QT), with Fed balance sheet reductions removing liquidity from the economic system. The Fed's balance sheet is down from $9.0 trillion in early 2022 to $7 trillion in January 2025. This is still much higher than the pre-pandemic level of $4.2 trillion in February 2020.
- The balance sheet QT is expected to end in 2025-2026 as the Fed reaches normalization

Looking ahead, there are reasons for strong optimism and caution:

- Policies being discussed to reduce regulations could enhance growth opportunities, but could also promote excessive risk-taking.
- Tariffs are already in place around the world. Any potential new tariff could be broad or targeted, producing the desired results or increasing global tensions.
- Tax policy is set to change through expiration of current tax laws. The upcoming tax debates can have a significant impact on the potential for economic growth.
- Artificial Intelligence is a historical innovation. We believe the current investment in AI has the potential to boost productivity and lead to new discoveries.

These are significant variables impacting investors. Opportunities always exist to invest in productive companies while exercising caution. Companies will continue to earn revenue by providing goods and services to their customers. While the market scales may weigh them positively or negatively for a period of time, a focus on long-term potential can prove rewarding.

Wishing you a healthy and Happy New Year!

The CMH Wealth Team

Sources include: Rosenberg Research, Various 2024 Issues. Goldman Sachs, *2025 Outlook: The Year of the Alpha Bet*, November 18, 2024. Goldman Sachs, *Global Strategy Paper #70 & #71*, October 18, 2024. Goldman Sachs, *Market Concentration: How Big a Worry?*, November 25, 2024. Goldman Sachs Asset Management, *2025 Outlook: Reasons to Recalibrate*, November 2024. J.P.Morgan, *2025 Year-Ahead Investment Outlook*, November 2024. J.P.Morgan, *How AI can boost productivity and jump start growth*, July 16, 2024. Vanguard, *Economic and Market Outlook for 2025: Beyond the Landing*, December 2024. Invesco, *2025 Investment Outlook: After the Landing*, November 19, 2024. White House, Fact Sheet: *CHIPS and Science Act Will Lower Costs, Create Jobs, Strengthen Supply Chains, and Counter China*, August 9, 2022. Data source providers include St. Louis Federal Reserve, FactSet, S&P Dow Jones, Tamarac, and providers to.

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